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SIPDIS

STATE FOR EUR/NB, EB/ESC, EB/OMA
DEPT OF COMMERCE FOR MAC/DAS/EUR MELISSA WILSON
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TAGS: ECON EINV ETRD LH
SUBJECT: LITHUANIA'S ECONOMY: WHY 2004 WAS SUCH A GOOD YEAR

Summary

¶1. Final 2004 figures confirm that Lithuania's economy remains on a roll. High growth, low inflation, and expanding foreign investment still characterize the economy. Surging domestic consumption fed Lithuania's growth, but also contributed to a growing current account deficit and upward pressure on prices. This year promises more good news, with only slightly lower growth. End summary.

Expanding Economy

¶2. The Lithuanian economy grew by 6.7 percent in 2004, boosting GDP to 22.3 billion USD. The construction and manufacturing sectors experienced the quickest growth. Domestic demand remains an important engine of economic expansion. Overall industrial production (measured by sales) grew by more than 10 percent, and by 12 percent in the case of manufacturing. The sales of refined oil products were triple those of 2003, reflecting the output of Lithuania's sole refinery, Mazeikiu Nafta. The company earned a record net profit of 721.8 million litas (USD 261.10 million) in 2004, compared to 220.9 million litas (USD 71.9 million) net profit in 2003. The food sector, which sells most of its production on the domestic market, recorded lower sales, but should perform better in 2005 if it can boost its export sales to the EU.

¶3. Lithuanian banks did well in 2004. The banking sector saw a net profit of 297 million Litas (USD 116 million), an annual increase of 27 percent. Strong economic growth, low interest rates on mortgages and consumer credit (averaging 4.51 and 5.72, respectively, for over-five-year loans), and confidence in the real estate market spurred a construction boom. Banks reported that loan portfolios rose almost 40 percent. All of Lithuania's commercial banks recorded profits in 2004.

¶4. Year-end consumer price inflation in 2004 reached 2.9 percent -- the highest since 1997. Lithuania's membership in the EU, although not the sole cause of inflation, turned out to be painful for consumers. Consumer hoarding of some basic commodities, such as sugar and bread, in anticipation of expected (but generally never realized) EU tax and price hikes, pushed up prices prior to Lithuania's EU accession. Post-accession, vast bulk purchases of Lithuania's relatively low-priced meat, for example, by buyers from other EU countries sent some prices soaring. Wage increases in many sectors, a response to worker flight to better-paying jobs in other EU countries, also had an inflationary effect on goods and services. Rising costs of domestic electricity and global fuel prices will likely keep inflation at 2.9 percent or higher in 2005, but analysts foresee inflation easing somewhat in 2006.

Public Finances

¶5. The GOL's fiscal position deteriorated somewhat in 2004, strong growth notwithstanding. The budget deficit increased from 1.7 percent of GDP in 2003 to 2.5 percent in 2004. This reflected a rise in pension costs, discretionary expenditures in the mid-year budget, and 2004 election expenses. The IMF advised Lithuania to broaden its tax base, in particular by expanding property taxation, and the GOL has proposed taxing commercial property at one percent of market value, beginning in 2006.

Declining Unemployment

¶6. The unemployment rate continued to drop in 2004. The official annual average unemployment rate (the ratio of the registered unemployed to the working age population) was 6.8 percent, down from 8.1 percent the previous year. The other

popular measure, that of the Lithuania Statistics Department's Labor Force Survey, pegged unemployment at 11.4 percent in 2004, the lowest rate in four years. One cause of declining unemployment is that Lithuania's accession to the European Union on May 1 stimulated and facilitated emigration. This trend, likely to continue as entry restrictions to the European labor market relax further, has led to shortages of skilled workers in engineering, construction, electronics, and IT, as well as to a growing need for truck drivers and low-skilled workers to fill positions in the restaurant and retail sectors. Unemployment in remote regions of Lithuania (e.g., Akmene and Mazeikiai) remains high, and the national unemployment rate is above the EU average.

¶7. Growing labor shortages last year caused an increase in average monthly earnings. According to the Lithuanian Statistics Department, the annual change was greater in each quarter of the year and reached 7.3 percent in the third quarter. Most business leaders and analysts believe that competition for labor from foreign markets and the local lack of qualified employees will result in even faster growth in average earnings this year.

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Foreign Direct Investment (FDI) Flows Increased
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¶8. After hitting a record low in 2003, total foreign direct investment flows in 2004 rose 18 percent over the 1998-2003 average with total inward proceeds of 2.15 billion Litas (USD 774 million). Year-end accumulated FDI reached 16 billion Litas (USD 5.8 billion), or 4,727 Litas (USD 1,700) per capita. The manufacturing industry, electricity, gas and water supply services, and wholesale and retail trade recorded the largest foreign direct investment flows in 2004. U.S. investment accounted for 372 million Litas, barely six percent of the total FDI inflow last year. Leading investors were Denmark (15.3%), Sweden (11.2%), and Russia (8.4%). With several significant U.S investments taking place in the first half of 2005, we expect to improve on this performance significantly this year.

Privatization Continues

¶9. The sale of a 34-percent stake in Lietuvos Dujos (Lithuanian Gas) to Russia's Gazprom for 100 million Litas (USD 35.7 million) constituted the largest privatization of ¶2004. Other sizeable asset privatizations in 2004 included the sale of 84 percent of the alcohol beverage producer Alita for 20.7 million USD, the Lithuanian Export and Import Insurance Company, and the Government's stake in the Stock Exchange and Central Depository. Receipts from privatizations declined from 910 million Litas in 2003 to 410.5 million Litas (USD 147.6 million) in 2004. Privatization is nearly complete. Only a few large assets, including the Eastern Power Grid, Lithuanian Airlines, and Lithuanian Railways, remain in Government hands.

Balance of Payments

¶10. The current account deficit (CAD) reached 1.6 billion USD (7.2 percent of GDP) over 2004, rising year-on-year by 587.5 million Litas (USD 211 million), or 15 percent, compared to ¶2003. The increased foreign trade deficit primarily accounted for the CAD's expansion, while the main factor keeping it in check was a higher surplus in the services balance. The country's vigorous growth, increasing income, and favorable borrowing terms fuelled domestic demand, which accelerated imports of consumer goods and exacerbated the merchandise trade deficit. Exports of Lithuanian goods increased by 21 percent, while imports grew by 15.8 per cent, year on year. Lithuania's trade with EU markets expanded. Annual export of goods to EU member states grew by 29 per cent, accounting for 66 percent of total exports. The only notable non-European export market was the United States, which accounted for five percent of sales in 2004.

Comment

¶11. The initiation this year of EU support fund disbursement will keep the economy growing at a rapid pace. In the long run, however, Lithuania will need to increase exports and attract more investment to ensure that the economy continues to expand. This will require the government to take on the long, hard task of improving its investment climate and carrying out structural reforms (including lower labor taxes) that make the economy more productive and competitive.
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